Research Department
Federal Reserve
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FRBSF Weekly Letter

Costs, Competition and the Prime

Regular readers of the financial press may have noted a growing divergence in the way the media treat the news about changes in the banks' prime business-loan rate. Most editors still give the prime a prominent place on the financial pages—"above the fold"—along with news about the stock averages, the money supply, and the price of gold. Others, however, are beginning to question the newsworthiness of the prime, arguing that it is no longer a useful barometer of the price of credit.

This questioning of the value of the prime reflects the growing tendency by banks to lend below the prime—in effect, discounting that rate. This behavior appears to violate the classic definition of the prime as the rate available only to borrowers with the very best credit credentials. Actual loan rates supposedly are always scaled upward from the prime, depending upon the risks of the loan or creditworthiness of the borrower.

In the words of one somewhat jaded banker, "Everybody worries about the prime rate, but few people pay it." Or in the words of another, paraphrasing Humpty Dumpty, "The prime rate means just what we want it to mean." Despite all such disavowals, changes in the prime are important to financial-market participants for their "announcement effect." The prime may not be an infallible guide to the direction of interest rates, but it remains a highly visible and reasonably representative indicator of changes in the general cost of bank borrowing. Consequently, we would profit from a review of the cost and competitive factors that determine this key rate.

Nature of the prime

Many people mistakenly believe that the Federal Reserve sets the banks' prime rate. (See our *Weekly Letter* of February 20, 1981.) Despite its strong impact on credit markets, the Federal Reserve certainly does not have "hands on" control of the prime. The Fed influences the environment in which that key rate is determined by controlling the rate of growth of money and bank credit. If actual money-supply growth diverges from the Fed's money targets, market participants tend to change their expectations regarding the future course of money growth, inflation and interest rates. Nonetheless, market forces of supply and demand for credit accommodation remain the key determinants of the level of money-market rates.

The prime rate itself, while quite sensitive to changes in the money market, is not determined directly by market forces. Rather, it is an administered rate—that is, determined by individual banks. On occasion, major commercial banks have linked their prime rates by formula to some market rate, such as the market for commercial paper or large-denomination certificates of deposit (CDs). A typical formula might include a spread of about 1½ percentage points over the average cost of commercial paper in the several preceding weeks, which would mean a prime of 18½ percent at the recent commercial-paper rate of 17 percent.

This method of setting the prime has lost popularity in the last several years because of the increased variability of market rates, and the banks that used that approach have reverted to setting the prime by administrative decision. Yet the prime is not immune from the forces of the market, despite the discretionary manner in which it is generally set. Banks set the prime to equalize the demand for credit with the supply of available funds, so that it represents the price which banks perceive will clear the market.

Costs and competition

In their rate-setting decisions, bankers pay close attention to the market quotes for large certificates of deposit (CDs), which are an important source of funds to banks when managing their liabilities and liquidity posi-

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tions. CDs have gained in importance in recent years, as banks suffered outflows of "core" deposits—demand deposits and low-cost savings accounts. But banks of course can "manage" their CD liabilities by their own rate decisions; for example, when loan demand is slack and a bank has ample funds, it can post a CD rate lower than the prevailing market rate to indicate its lack of interest in attracting more funds.

Competitive factors, as well as costs, affect banks' rate-setting decisions. Major corporations with the highest credit ratings don't have to borrow from banks, but instead can issue their own IOUs in the highly-organized commercial-paper market. The commercial-paper rate currently is running about three percentage points below the prevailing prime. Not surprisingly, then, outstanding nonfinancial commercial paper has doubled since the end of 1978, in contrast to a 12-percent rise in domestic banks' outstanding commercial loans over the same period.

Foreign banks also have come to play a major role in this competition for corporate business, and now account for about one-sixth of all business loans—considerably more in the key New York and California markets. These banks, despite growing restrictions on their U.S. activities, can channel low-cost funds from abroad to U.S. business borrowers. The key rate in this competition is the LIBOR (London Interbank Offer Rate), which has been running at least three percentage points below the prevailing prime. (LIBOR is not clearly analogous to the prime rate because it is generally quoted on a maturity basis; for example, the one-to-six month cost of Eurodollar balances.) In any event, the availability of low-cost commercial paper and foreign loans has forced domestic banks to reduce the price of credit to the very best of their "best" customers. It should be noted, however, that most banks have offered below-prime rates only on very short-term loans.

Recent rate trends

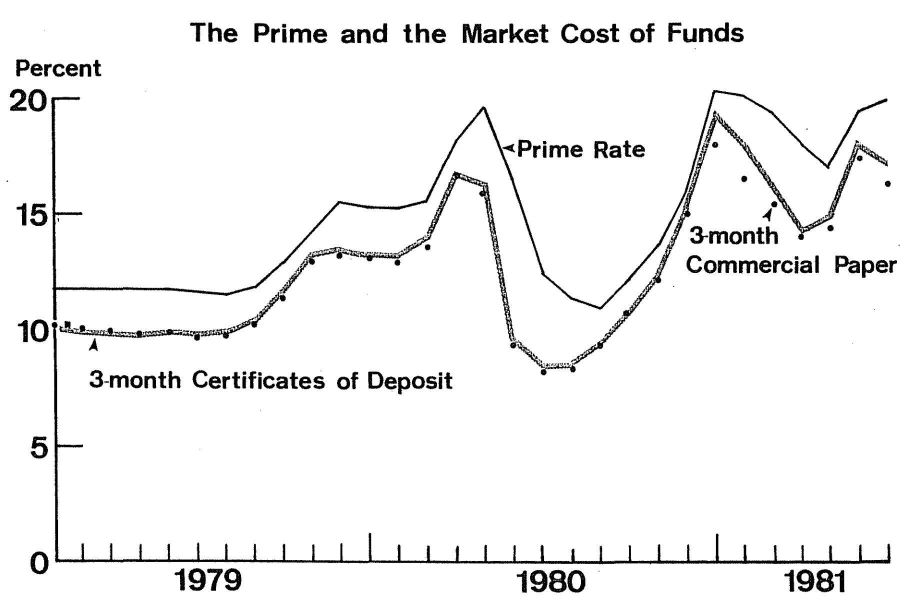
The prime rate has fluctuated substantially in recent years, along with those rates that bankers watch when setting the prime (see chart). During the first half of 1979, the prime rate remained steady at 11¾ percent, while the commercial-paper and CD rates ranged around 10 percent or a little lower. (Commercial-paper and CD rates generally move closely together, because they represent alternative short-term investments to the average investor.) Market rates rose sharply after mid-1979, reflecting rising inflation rates and investors' expectations of worse to come. As those rates rose, banks began to boost the prime, until it reached 20 percent in April 1980.

The short but sharp business downturn in the spring months reduced market rates by half within a month's time. Tight credit controls, plus recession-influenced rate expectations, pushed market rates down during this period—and pushed the prime down in their wake. But rates recovered sharply with the second-half 1980 business recovery—and they have remained high (although sharply fluctuating) so far this year because of a tighter monetary policy, shifting credit demands, and a stand-off between decelerating price indexes and fears of a future resurgence of inflation.

The prime rate, while not directly market-determined, certainly responds to the same factors that act upon market rates. This helps explain both the stratospheric level of the quoted prime rate and the pressures forcing a discounting of that rate. On the one hand, banks now rely heavily upon deposits or liabilities that they obtain in the money market, for which they must pay the going market rates. On the other hand, banks must respond to the competition for business financing, whether arising from the commercial-paper market or from foreign sources.

The prime rate thus has become more responsive to market pressures over time, such as market participants' expectations regarding the trend of inflation and interest rates. When market participants foresee a decline in the inflation rate, money-market rates will begin to decline. And since market rates represent banks' marginal cost of funds, the prime rate at that point will also begin to decline.

Herbert Runyon



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/24/81	Change from 6/17/81	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	150,268	631	13,273	9.7
Loans (gross, adjusted) — total#	128,549	750	13,068	11.3
Commercial and industrial	38,398	477	4,924	14.7
Real estate	52,713	84	5,907	12.6
Loans to individuals	23,008	50	− 870	− 3.6
Securities loans	1,644	52	699	74.0
U.S. Treasury securities*	6,340	− 85	12	0.2
Other securities*	15,379	− 34	197	1.3
Demand deposits — total#	39,730	−1,000	− 1,613	− 3.9
Demand deposits — adjusted	28,035	166	− 2,480	− 8.1
Savings deposits — total	29,878	− 309	2,149	7.8
Time deposits — total#	81,156	1,137	17,525	27.5
Individuals, part. & corp.	72,223	1,254	17,428	31.8
(Large negotiable CD's)	32,029	1,341	9,352	41.2

Weekly Averages of Daily Figures	Week ended 6/24/81	Week ended 6/17/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	n.a.	n.a.	− 55
Borrowings	389	135	1
Net free reserves (+)/Net borrowed(−)	n.a.	n.a.	− 56

* Excludes trading account securities.
# Includes items not shown separately.

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